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TAGS: ECON EFIN EINV EMIN ENRG EPET ETRD SA
SUBJECT: STEEL MARKET ILLUSTRATES CHALLENGES IN REALIZING
THE GULF DEVELOPMENTAL BOOM

Classified By: CG JOHN KINCANNON FOR REASONS 1.4 (B) AND (D)

¶1. (C) SUMMARY: With Gulf countries eager to translate windfall oil profits into global commercial leadership, the GCC project market has boomed, recently surpassing two trillion USD - more than double the combined GDP of the GCC economies. With massive industrial, utility, and real estate projects comprising the bulk of planned construction, the regional demand for steel and other raw materials has soared. A tight global steel market, along with record oil prices and a weak U.S. dollar, has caused steel prices to double within the last ten months. Though steel demand has proved surprisingly inelastic, increased prices and supply shortages have created important challenges for local development, including project delays, shaken investor confidence, and rising inflation. Saudi Arabia and other Gulf countries have sought to counter the overheating market by increasing regulation, but with little success. GCC countries hope that long-term investment in new steel manufacturing plants will alleviate constraints by expanding production capacity. The ability to meet and subsequently manage steel market pressures will prove telling in the region's attempts to create sustainable growth. END SUMMARY.

Oil Wealth Creates Booming Project Market

¶2. (U) With the price of oil at all-time highs, Gulf economies are enjoying windfall profits and unprecedented liquidity. Saudi Arabia, along with the rest of the GCC, has moved to focus investment of these funds on further developing hydrocarbon resources, resolving pressing societal needs - for example housing and utilities, and placing the Gulf at the vanguard of commerce and culture.

¶3. (U) Comprising a significant portion of the more than two trillion USD in planned projects are integrated economic development projects that Gulf countries are hoping will satisfy growing housing demand and provide needed jobs for the region's fast-growing population. Not content to simply meet population needs, these projects often aim for unprecedented technological or architectural feats. Saudi Arabia's economic cities - with projects at Rabigh, Hail, Madinah, Jizan, Tabuk and the Eastern Province (EP) - hope to create more than one million jobs and become home to between four and five million people by 2020. Reliable cost estimates for the Economic Cities projects seem not to exist; a June Arab News article estimated Rabigh, Hail, Madinah and Jizan at more than 300 billion SAR, while a July Bloomberg News article estimated the King Abdullah Economic City at Rabigh as being 120 billion USD itself. Virtually every other Gulf country has grand visions of their own, whether it be Kuwait's 77 billion USD City of Silk or any one of the myriad UAE projects.

Steel Demand Grows, Prices Spike

¶4. (U) Monumental in imagination, size, and number, projects such as these have created an unprecedented demand for raw materials, chief among them cement and steel. In 2006, the Middle East produced 21.1 million tons and consumed 41.6 million tons of raw steel. The Middle East Economic Digest (MEED) forecasts that by 2010, these numbers will reach 35 million and 60 million, respectively. Growing local demand for steel dovetails with a tight global market created in large part due to Chinese steel producers transitioning away from export and instead focusing on the domestic market. The world's three largest iron ore producers - Brazilian Vale and Australian Rio Tinto and BHP Billiton - have responded to this global demand by increasing 2008 prices between 65 and 96.5 percent, depending on region and iron ore quality.

¶5. (C) According to Abdullah al-Zamil, COO of Zamil Industrial, increased demand and rising iron ore prices are only part of the reason for spiking steel costs. In a July 14 meeting with EconOff, al-Zamil explained that the cost of oil, used in producing and transporting steel, and the weakness of the U.S. dollar are also important factors. Al-Zamil estimated that the drop in value of the U.S. dollar was responsible for some 20 to 25 percent of the rise in the price of steel. President of Zamil Steel Industries Adnan al-Mansour added that while his company paid some 300 USD for a metric ton of steel plate in 2003, and 750 USD in October 2007, in June 2008 the cost was 1,400 USD. The price stated

by al-Mansour is slightly lower than publicly reported figures in the region, which continue to rise. On July 21, Arabian Business website reported that in the past two weeks alone regional steel prices had increased another ten percent.

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As Steel Price Soars, Problems Arise and Projects Stall
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¶6. (C) Despite the unprecedented rise in steel prices, demand has remained surprisingly inelastic, in turn only further driving up prices. But, though the industry has continued to grow, problems have begun to arise. Market confidence has eroded as long-term planning has become extremely difficult. With prices increasing so rapidly, Zamil Steel President al-Mansour reports that many contract bids will often now have only a 24-hour validity as any greater time period creates too much risk of price fluctuation. In addition to eroding investor and consumer confidence, such risk has created a severe disadvantage for smaller contractors, as they do not have the same ability as larger contractors to hedge, negotiate favorable terms with suppliers, and generally benefit from economies of scale. If the number of contractors shrinks, the resulting oligarchic market will likely create even higher prices.

¶7. (U) Government contracting has also suffered, as governments continue to underestimate the cost of projects. According to an anonymous EP contractor speaking to the MEED in April, 55 percent of the Saudi Transport Ministry's 2008 budget is being spent on projects originally scheduled to be completed in 2007. Government infrastructure projects are now being completed in stages, with completion packages following the original contract. While this creates shorter timelines and mitigates price inflation, the lack of continuity has created concerns of decreased project quality. Articles in economic journals indicate that contractors are beginning to avoid the Saudi and Kuwaiti markets where lump-sum turnkey contracts are common and instead prefer markets such as Abu Dhabi, where risk-sharing through "cost plus" contracts is more common.

¶8. (C) Market conditions have caused extreme fluctuations in project estimates. The Saudi Aramco and Total joint venture refinery at Jubail, originally estimated at 6 billion SAR in 2006, was re-estimated at between 11 and 12 billion SAR when the agreement was signed in June 2008. COO al-Zamil of Zamil Industrial told EconOff that a large Saudi Consolidated Electricity Company (SCECO) project estimated at between five and six billion SAR 12 months ago is now estimated to cost 11 billion SAR. Demand for refined oil and electricity made these cost considerations secondary for the SAG, however. Project delays have become commonplace throughout Saudi Arabia and the region. Aramco's Khursaniyah oil and gas project is currently eight months behind schedule due to labor and raw material shortages. Shareef Abu Auf, CEO of Al-Haramain Co. for Contracting reported to Arab News in May that steel shortages have not allowed for completion of the Hajj Terminal lounge at the King Abdul Aziz International Airport in Jeddah. Likewise, Abu Auf added that the completion of public works in the Jeddah area, converting major roads to under- and overpasses, has been hampered by steel shortages. In addition to projects being delayed and over budget, other regional plans have been cancelled. In 2007, Dow Chemicals and ConocoPhillips pulled out of projects in Oman and the UAE, respectively, and local contacts report that Saudi Aramco has mothballed two projects, one industrial and one petrochemical, due to rising costs.

Attempts to Respond to Market Challenges

¶9. (C) The SAG has attempted to respond to these severe market pressures. In response to the current steel crisis, in early June, the Ministry of Commerce and Industry moved to limit steel exports. According to Zamil Steel President al-Mansour, the Ministry originally threatened to prohibit all steel exports, including items such as pre-fabricated steel structures produced from previously imported steel. After negotiations with steel industry leaders, the Ministry instituted a more reasonable requirement of obtaining an export certificate from the Ministry. According to a June 11 Arab News article, the Ministry requires exporters to give details regarding the source of the goods, destination of the goods, and the contract with the buyers. Permission to export is only granted after ensuring local steel

requirements have been met. Export restrictions have also been instituted for iron and cement.

¶10. (C) The Saudi Ministry instituted these policies due to suspicion of foul play by local steel distributors who buy from steel producers such as Hadeed, the steel arm of Saudi Basic Industries corporation (SABIC), and sell to local contractors. Accusations, denied by local steel distributors, allege that the companies hoarded steel in an attempt to drive up prices, and additionally sought first to sell steel to other markets, such as Dubai, where prices were slightly higher. In a July 20 meeting with EconOff, SABIC Strategic Purchasing Manager, Mansour al-Harbi - responsible for obtaining iron ore among other inputs - said that this black market had become a reality and praised the SAG for its regulatory efforts. Al-Harbi claimed that the SAG did not harshly impose these rules, but rather worked with industry experts. Al-Harbi added that Hadeed had also begun directly supplying to contractors in an attempt to remove the middle-men. At this time, however, ninety percent of Hadeed steel is still supplied to local steel distributors. The long-term effects of Saudi and other GCC governments' efforts is unclear, though price growth has not slowed in the short-term.

¶11. (C) Understanding that short-term government regulation is a temporary solution at best, and that the regional boom will require massive amounts of steel, GCC countries have realized that only by boosting steel production will they be

better able narrow the gap between regional supply and demand and perhaps cool the overheating market. According to a June 10 article in Arab News, 18 billion USD has already begun to be invested in 46 new steel manufacturing plants in the Gulf. Of these 46, 17 will be in Saudi, 16 in the UAE, 13 in Oman, four in Bahrain, and three in Qatar. According to industry association Arab Steel, as of early 2008, Saudi Arabia - which currently consumes an estimated 11 million tons of steel annually - had the ability to domestically produce 8.43 million tons of steel, of which Hadeed accounted for 5.5 million. SABIC's al-Harbi told EconOff that Hadeed intends to triple capacity to between 15 and 16 million tons by 2020. Hadeed announced the beginning of such efforts on July 13, 2008 by signing a deal with Saudi Arabia Fertilizers Co (SAFCO) to set up a new Jubail steel factory of 1.7 million metric tones. Hadeed also recently announced plans for a new facility capable of producing 500,000 metric tons of rebar and wire rod annually.

¶12. (U) In addition to increasing output, industry analysts predict that Middle Eastern steel producers, and particularly those in the GCC, must consolidate if they are to remain globally competitive. The regional market is currently highly fragmented, comprised primarily of small producers who will struggle to remain competitive with global industry leaders. Meanwhile, Saudi Arabia's largest steel producer has hinted it might not stop at simply increasing steel production. SABIC has also indicated that it has interest in vertically integrating by making large investments in the global iron ore sector. Though SABIC cancelled 2007 arrangements to acquire iron ore mines in Mauritania (instead, Qatar Steel Company assumed SABIC's stake in the project), several SABIC officials have anonymously reported to investment publications in 2008 that the company is organizing a mining acquisition portfolio to aggressively enter the iron ore market.

Questions on the Future of the Boom

¶13. COMMENT: (C) With a large percentage of the two trillion USD in announced projects comprised of hydrocarbon-related investment and integral population needs, such as expanded utilities, it is probable that most projects will be completed in the final tally - governments will simply be too committed to let them fail. But while the future of oil and gas investments looks clear, some suggest that the Gulf is experiencing a market bubble, particularly in the real estate sector. These concerned voices caution that the pace and magnitude of projects are grander than the market will support. With only one quarter of the more than two trillion USD in projects currently under construction, there is still much unclear about the fate of the boom economy.

¶14. (C) Thus far, the market has allowed each level of vendor to pass the increased cost of inputs on to customers, but fear exists regarding what happens when end-consumers finally

reach their price limit. In the event of a hard landing, investors in unrealized projects will be left in a lurch. Likewise, completed projects might find tepid demand for luxury condos, offices, and kilometer-tall buildings. Even if the booming market continues along with only minor hiccups, how governments manage consumer and investor confidence, as well as rapidly growing inflation, will play a significant role in regional political stability and civil society development. This cable investigates the place of steel in the Gulf boom, but factors such as other raw materials and human capital will also play a key role in the Gulf's development. The Gulf has become the cutting edge of investment and development due to what many see as a fundamental shift in global economics. Windfall oil profits and massive projects, however, must be effectively managed if they are to bring sustainable success. END COMMENT.

(APPROVED:JKINCANNON)
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